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Application of a Flat Tax Rate for Individual Income Tax

Prepared for the Citizens Finance Review Commission

by

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1. What it is

In general, Arizona state income tax is a tax on income derived from all sources less exemptions and deductions. Individual income tax rates are graduated such that rates increase as income is higher. Arizona currently has five individual income tax brackets and a single corporate income tax rate.

This paper analyzes a proposal of a “flat tax”. There are many different versions of what a flat tax is. Some versions of a flat tax eliminate all deductions and redefine what income is. Several versions of a flat tax were introduced in Congress in the 1990’s as an alternative to the Federal income tax. Others view a flat tax as simply being an elimination of the graduated tax brackets and instead having a single rate applied to net income.

Because Arizona uses the Federal income tax as a starting point for its income tax and because different reports address the elimination of the corporate and individual income tax deductions, this report will analyze the elimination of the graduated brackets and instead have a single tax rate.

As the corporate income tax already has a single tax rate, this report will address the application of a single rate on the individual income tax only. Individual income tax does apply to partnerships, sole proprietorships and some LLCs. So the proposal would impact the tax on these entities.

2. How it would be administered

Legislation would need to be enacted to change the current graduated rate structure of the individual income tax to a single rate. If in setting the tax rate, money to the state general fund increased, then a two thirds majority would be needed to pass the legislation. If in setting the tax rate, income to the state general fund did not increase, then a simple majority would be needed to pass the legislation.

The Department of Revenue would implement the change by revising the forms and instructions, but the revisions would be minor compared to changes that are done annually anyway.¹

3. Impact on existing revenue systems

Income tax funds are deposited directly to the state general fund and should not impact any other revenue streams. However, the amount of income tax collected by the state

¹ To implement a more comprehensive version of a flat tax, that is, one that not only imposes a single rate, but also eliminates deductions and redefines income, the state would have to rewrite its entire individual and corporate income tax code (Title 43).

helps determine the amount of revenue sharing available to the cities. Thus, if the tax rate is set such that more income tax is collected by the state, then the cities would share in the increase in collections. Conversely, if the tax rate is set such that less income tax is collected by the state, then the cities would receive less money from the state in revenue sharing.

4. Cost

The cost of administering any changes would be modest because the mechanisms for collecting, processing and auditing income tax returns and reviewing and revising tax forms are already in place. Similarly, there would be no additional cost to the taxpayer as the only thing that would change would be the tax rate that is applied.²

5. Policy Considerations³

A. Equity

Moving from graduated tax rates to a single tax rate decreases the progressivity of the tax. Since the personal exemptions would still be in place, having a single tax rate still provides for some level of progressivity.

B. Economic Vitality

California, Colorado, Georgia, New Mexico, Oregon and Utah have a personal income tax. Of those states, California, Georgia, New Mexico and Utah have six or more tax brackets. Oregon has 3 brackets. And Colorado has a single tax bracket. Nevada, Texas and Florida do not have a personal income tax.

Imposing a single tax rate still does not make Arizona competitive in the area of individual income tax compared with Nevada, Texas and Florida unless the rate is zero. However, depending on what rate is applied, having a single tax rate will probably make Arizona more competitive for high income earners compared with states that have more graduated tax brackets. Similarly, whether the proposal implements a rate higher or lower than Colorado and Oregon will determine its competitiveness with those states.

As stated in the report on *Possible Reforms to Arizona's Individual Income Tax*, the economic literature is divergent on the impact of progressive personal income taxes on economic growth. Some specific analysis found no relationship between tax progressivity and economic performance or income growth. Other analyses found a relationship under very specific circumstances (strong regional economic growth and

² The cost of implementing a more comprehensive version of a flat tax would be extensive both to the taxpayer and the tax collector as the tax code would be completely rewritten and would no longer conform to the Federal tax code. See footnote 2.

³ There would be additional policy considerations in a more comprehensive version of a flat tax. For example, under certain versions of a flat tax the double taxation of corporations is eliminated.

regional competitors having very different levels of progressivity). (Howard Chernick, Hunter College and Graduate Center, City of University of New York, *Tax Progressivity and State Economic Performance*, Economic Development Quarterly, August 1997, vol. 11, no. 3).

A 1991 paper delivered at a National Tax Association meeting reported that “state personal income taxes most likely do have an effect on regional competition” but primarily in states with significant manufacturing industries. (Sally Wallace, *The Effect of State Personal Income Tax Differentials on Interstate Competition*, State Tax Notes, December 23, 1991). Wallace notes that one limitation of her work is the lack of measurement on the trade-offs between taxes and expenditures.

Some argue that graduated rates discourage income growth and deter higher income individuals from moving to a state. (Stephen Slivinski, *The Right Cure for What Ails Us: A Prescription for Comprehensive Tax Reform in Arizona*, Goldwater Institute, June 9, 2003).

C. Volatility

According to analysis from the Arizona Joint Legislative Budget Committee (JLBC), Arizona’s current income tax structure tracks economic growth as measured by personal income. Income tax revenue growth tends to be a bit higher than economic growth during “good” times and lower than economic growth during recessionary times. The personal income tax is more elastic than the sales tax, but far less volatile than the corporate income tax. The range of tax brackets were narrowed in Arizona during the 1990s and there did not seem to be a significant change in the volatility of the tax collections. So, changing to a single tax rate will probably not change the overall volatility of the tax collections, although there is no data available to make that determination.

D. Simplicity

Taxpayers would not have to refer to a table when calculating the tax owed but instead would just apply a percentage to the net income. But such a change is probably negligible.

6. **Economic Impact**

The amount of revenue collected will vary depending on the tax rate applied. The amount of revenue collected by the state could increase with a higher rate and decrease with a lower rate.

The Department of Revenue conducted studies of the impact of certain flat taxes.⁴ In a study that lowered the flat tax rate to 3%, but retained all current deductions and credits,

⁴ The study used actual returns of 40,000 Arizona tax filers in 1999, extrapolated to the total number of tax filers. The study broke down tax filers by federal adjusted gross income, to see how changes in rates would affect different income tax levels. Those levels were:

the impact was a loss of \$332,298,023 of income tax revenue, a reduction of approximately 19%. We chose a 3% flat tax rate because it tended to lower the ultimate tax burden on most tax payers and only very moderately increase tax burdens (on average) on the lowest income tax payers, those within the \$10,000 to \$30,000 federal adjusted gross income bracket.

On a revenue neutral basis, the flat tax rate would have to be 3.54%. The effect is that all of the tax payers within the \$10,000 to \$100,000 federally adjusted gross income bracket would see a rise in tax liability and the tax payers within the \$100,000 to over \$1 million federally adjusted gross income bracket would see their tax liability fall. The tax increase is highest, as a percentage, in the lower income brackets. The tax decrease is highest, as a percentage and in actual dollars per typical tax payer, in the highest income brackets.

Negative Fed. Income

\$0-10,000

10,000-20,000

20,000-25,000

25,000-30,000

30,000-40,000

40,000-50,000

50,000-75,000

75,000-100,000

100,000-200,000

200,000-500,000

500,000-1,000,000

Over \$1 million